Will private insurers rescue leaking flood insurance program – or drown it?

CBS Money Watch

Privatizing federal programs is a mantra of President Trump and the Republican-controlled Congress. The National Flood Insurance Program NFIP) — up for renewal at the end of September — is a perfect target. Already in debt to the tune of $25 billion, plagued by scandals, and so faulty that even environmentalists are joining the chorus of criticism, the NFIP is still likely to stay in business for at least another five to 10 years. Without the NFIP, however, construction of new homes and businesses for almost half the country — the 144 million people who reside in coastal and flood-prone areas along the coasts — would literally dry up. Banks cannot grant mortgages to buildings without insurance and vulnerable low-lying areas can't generally get flood insurance without the NFIP.

But Congress is considering some extensive changes. Wisconsin Rep. Sean Duffy, Republican chairman of the House Financial Services Committee subcommittee on housing and insurance, has submitted a "draft proposal" that would permit private insurance companies to hunt in what has mostly been the NFIP's private preserve for the last 50 years. It would eliminate the "non-compete" clause that fenced them out. Despite misgivings, most agree it should happen. "This is a good start," said Amy Bach, a fierce consumer advocate who oversees United Policyholders and has been counseling many Gulf Coast flood victims. "But we've got a long way to go."

Even NFIP administrator Roy Wright doesn't object. "This shows an incredible amount of work," he said, predicting that — at least in this case — the odds are favorable that Democrats and Republicans can strike a deal.

Going forward will not be easy, however. Many people have a healthy fear of private insurers invading protected waters, seeing them as sharks trolling bathing beaches. One fear, said Director of Insurance Robert Hunter of the Consumer Federation of America, is that private companies will "cherry pick" the best customers and leave the rest to the ailing NFIP, which will cause it to fall even further into debt. Another fear is that insurers unlicensed by state regulators will take on and then drop customers after a major hurricane — without paying their claims.

Hunter said it happened before when insurers “walked away from claims” in 1992 riot-torn Los Angeles after the initial O.J. Simpson verdict. Given the potential for a trillion dollars in claims if a Katrina-like hurricane scored a direct hit on Miami, it could happen again.

The NFIP was established in the 1960s when private insurers refused to take on the huge risk associated with major floods, such as the storm surge of Hurricane Katrina in 2005, which devastated New Orleans, or Superstorm Sandy in 2012, which wreaked havoc on New Jersey and New York. Katrina cost the second largest domestic home insurer, Allstate, $3 billion in wind damage alone.

But recently, property-casualty insurance companies — aided by “big data” and supercomputers — have become more sophisticated in handling major storm risks, and are now ready to take on this market. Nat Wienecke, who handles government affairs for the Property Casualty Insurance Association of America, said the group is “pleased” that federal legislators want to “facilitate more private flood insurance coverage.”

Meanwhile, the NFIP has drifted from disaster to disaster like a dismasted ship hitting reefs, in an average year it takes in barely enough policyholder premiums to stay afloat, so it can handle claims for flooded basements. But big battering storms such as Category 5-level Hurricane Matthew in 2016 continue to push it underwater. “This program teeters on the edge of solvency,” said Steve Ellis, vice president of Taxpayers for Common Sense.

And like many government programs, it creates more problems than it solves. By charging many policyholders just 35 percent to 45 percent of their actual risk of flooding, the NFIP has subsidized waterfront construction in too many places where it never should have occurred. Then, when the flood hits, the NFIP — and ultimately the federal government — pays out billions of dollars in “beachfront bailouts” to owners of expensive homes, said critics such as Robert Hartwig, the former head of the Insurance Information Institute, which represents the industry.

Environmentalists support private insurance because when you price flood coverage correctly, it “stops new development in high-risk areas,” said Legislative Director Joshua Saks of the National Wildlife Federation. If it’s too expensive, you won’t get be able to afford it and you won’t build your house in an environmentally sensitive marsh that could be home to migrating birds and all sorts of land and sea animals.

So, what else is wrong with the NFIP? For starters, its flood maps are as outdated as hieroglyphs, said critics. And this comes at a time when oceans are warming and sea levels are rising, creating a petri dish for hurricanes, which thrive on hot water. A recent CoreLogic report for 2017 said that nearly 7 million homes along the Atlantic and Gulf coasts are at risk of damage from hurricane storm surge.

The NFIP is so financially strapped that it was caught in a scandal for “lowballing” claims after

Superstorm Sandy, where engineers were encouraged to lie, stating that the homes which flooded off their foundations only had minor damage. And the scandals and bad publicity haven't helped the NFIP retain clients. The number of homeowners with flood insurance policies dipped to five million last year, down more than 12 percent from its high in 2009.

So, should private insurers get in the game? Theoretically this would balance the scales and ensure that those living on the coast or near frequently flooding rivers like the Mississippi would pay the right amount for coverage.

But simply raising the cost of flood insurance for those already paying as much as $4,000 a year would force people — say, Mississippi sharecroppers who live near a river or creek — out of their homes. And many of them can't afford to move. Previous efforts to right the ship by raising NFIP flood rates only created a huge outcry that led to Congressional backtracking in 2014.

And despite wanting to enter the flood insurance market, private insurers don't want in all at once. They will take four or five years to get their feet wet, said Chris Grimes of FitchRatings. "We'd see slow growth at the start as private insurers get the necessary data and do their analysis," the insurance analyst predicted.

Meanwhile there is general agreement to keep the NFIP limping along beside the private market, while sharing its data and claims base with private insurers to ensure that they price their policies correctly. So, instead of just subsidizing customers, the NFIP would now also be helping insurers.

The Consumer Federation's Hunter has a problem with that. Private insurance companies, which are in business to make money, are likely to pick up the best risks and leave the worst for the NFIP to insure. Then, as NFIP rates rise to meet the risks, more people will leave the NFIP behind, leaving the program with less money with which to work. Insurers call that "a death spiral."

Another problem: Members of the House of Representatives, such as California Democrat Maxine Waters, want to add another layer of defense against private insurers: "guardrails" to prevent them from raising rates too much. Waters also wants Congress to "forgive" the NFIP's $25 billion debt. That seems unlikely to win the approval of the GOP majority in both houses.

All this is likely to delay, but not defeat, the effort to reform flood insurance. Proponents of letting private insurers into the market point out that they have been doing this in the United Kingdom, which has seen severe flooding in recent years, as well as elsewhere in Europe. They also say that private insurers, like Lloyds of London, are already in the U.S. market providing surplus insurance to homes that are worth more than the $250,000 basic coverage the NFIP provides.

The other hope is that these insurers will sell "all-risk" policies. While not every homeowner needs flood insurance, they do have risk from fire, wind and other hazards. By combining these policies into one, private insurers may make them salable. If the large foreign insurers such as Munich Re enter the U.S. market, they could lower the cost of policies by balancing them against the risk of similar tragedies overseas and make them profitable.

Advocates of private insurance say that a public-private insurance partnership can work, as it has in hurricane-prone Florida, where a large number of homeowners were once insured by a state-run insurance company. Most of those homeowners have now shifted to private insurers, backed by capital from Bermuda and overseas. So far, it's worked out.